84-1770

Office-Supreme Court, U.S.
FILED
APR 3 1985
ALEXANDER L. STEVAS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1984

NO.

WACO FINANCIAL, INC. *Petitioner*

and

J. JEROME PREVATTE *Petitioner*

vs.

SECURITIES AND EXCHANGE COMMISSION *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTIONS PRESENTED

1. To what extent do constitutional standards of procedural due process apply in administrative adjudicative proceedings?

2. Must claims regarding the constitutionality of administrative proceedings be administratively exhausted prior to an agrieved party asserting such claims as an affirmative defense in judicial enforcement proceedings?

3. May substantive changes and material alterations be made pursuant to FRCP 30(e) without the changing party being required to submit at his own expense to further examination?

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* * * * * *

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

* * * * * *

The Petitioners, WACO Financial, Inc., and J. Jerome Prevatte, respectfully pray that a writ of certiorari issued to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on January 3, 1985.

OPINION BELOW

The final judgment and opinion of the United States Court of Appeals for the Sixth Circuit is reported as Security and Exchange Commission vs. WACO Financial, Inc., and J. Jerome Prevatte, 751 F.2d 831 (1985), and is reprinted in the Appendix, infra at 1A. The opinion of the United States District

Court for the Western District of Michigan from which the Sixth Circuit Appeal was taken and is reported at 518 F. Supp. 651 (1981).

JURISDICTION

The opinion and judgment of the United States Court of Appeals for the Sixth Circuit was entered on January 3, 1985 and this petition for certiorari is timely filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254 (1).

CONSTITUTIONAL PROVISIONS INVOLVED

United States Constitution, Fifth Amendment:

> "No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

STATUTORY PROVISIONS INVOLVED

15 U.S.C. §78o(b)(7)(8) set forth in the Appendix infra at p. 7A.

15 U.S.C. §78o-3, set forth verbatim in the Appendix infra at p. .

STATEMENT OF THE CASE

A. NATURE OF THE LITIGATION.

This litigation arises from an enforcement proceeding brought by the Securities and Exchange Commission against WACO Financial, Inc., a small Kalamazoo, Michigan broker-dealer and its President and principal stockholder, J. Jerome Prevatte. In its District Court Complaint, the SEC charged violations of certain provisions of the Securities Exchange Act of 1934 [Section 15(b)(7), 15 U.S.C. § 78(o)(b)(7) and Rule 15B8-2(a) promulgated thereunder, 17 C.F.R. 240.1582(a).] The SEC's Complaint alleges that WACO and Prevatte, having been disciplined by the National Association of Securities Dealers were precluded from dealing in securities under 15 U.S.C. § 78o(b)(7). The essence of the defense was that the disciplinary proceedings violated rights of WACO and Prevatte to due process of law secured by the First Amendment to the Constitution of the United States. There

has never been a trial of these issues on the merits. Instead, the United States District Court for the Western District of Michigan granted summary judgment for the SEC, and entered an Amended Judgment and Order granting the injunctive relief sought by the SEC.

WACO, Financial, Inc., and Mr. Prevatte appealed from that Judgment pursuant to 28 U.S.C. §1291 to the United States Court of Appeals for the Sixth Circuit, asserting that the district court improperly resolved material and disputed issues of fact, thereby depriving WACO Financial, Inc., and Prevatte of their right to a plenary trial, and further asserting that the District Court improperly upheld the constitutionality of certain disciplinary practices and proceedings which form the premise upon which the SEC's enforcement action is grounded. The Sixth Circuit affirmed.

B. THE COURSE OF PROCEEDINGS.

Prior to the initiation of these proceedings by the Securities and Exchange Commission[1], the Appellant WACO Financial, Inc., was a small securities broker/dealer in

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[1] The Appellee Securities and Exchange Commission is sometimes hereinafter referred to as "SEC", and the Appellant WACO Financial, Inc., is sometimes hereinafter referred to as "WACO".

Kalamazoo, Michigan. Appellant J. Jerome Prevatte served as its president.

WACO Financial, Inc., filled a unique role in the Kalamazoo investment community as the sole broker/dealer offering discount brokerage commission rates to the general public. (Transcript, Preliminary Injunction Motion hering of July 1, 1981, p. 81).

In November, 1980, the National Association of Securities Dealers[2] commenced disciplinary proceedings against WACO and Mr. prevatte.[3] The constitutional claims asserted herein by WACO and Prevatte arise from these disciplinary proceedings and subsequent administrative appellate proceedings. Such proceedings, although nominally done by a private group of securities dealers, are actually conducted pursuant to and in exercise of governmental regulatory authority delegated to the NASD as a self-regulatory organization in the securities industry under the Securities Exchange Act of 1934. (15 U.S.C. §78f, 78o-3).

Based upon the outcome of these disciplinary proceedings

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2 The National Association of Securities Dealers is hereinafter referred to as the "NASD".

3 NASD District 8 Complaints CHI - 654, CHI - 659,

conducted by the NASD as a registered national securities association, the SEC initiated the present litigation and obtained a permanent injunction in District Court against WACO and Mr. Prevatte. The SEC claimed that WACO was not quailfied to function as a broker/dealer in the securities industry and Prevatte was not qualified to function as an associated person, respectively.

WACO and Mr. Prevatte defended, inter alia, by claiming that the NASD proceedings denied them due process of law under the Fifth Amendment, and asserted that such constitutionality defective administrative adjudications may not be utilized by the SEC to justify the injunctive relief which put them out of business.

C. FACTUAL BACKGROUND.

The National Association of Securities Dealers, Inc., is divided into thirteen Districts. District No. 8 encompasses the states of Illinois, Indiana, Iowa, Michigan, Minnesota, Wisconsin, North Dakota, and South Dakota. (Deposition of NASD District Director Craig Dearborn, p. 3, see Appendix).

Each NASD District has a staff managed by a district director and is governed generally by a District Committee. The District Committee is elected from those members of

the securities industry having a place of business located within the geographic boundaries of the District[4]. (Dearborn Deposition, p. 7).

The adjudicative functions of the District (which are the basis of Appellants' claims) are handled by a District Business Conduct Commitee. As stated in the aforesaid Disciplinary Procedures manual, at 2:

> "The enforcement of the Association's By-Laws, Rules of Fair Practice and policy interpretations rests primarily with the DBCC's District Committees operate pursuant to delegated authority from the Board of Governors."

The NASD procedures are formally governed by NASD By-Laws, Article VII, NASD Manual (CCH) ¶ ¶ 1503 - 05; NASD Rules of Fair Practice Article IV - V, NASD Manual (CCH) ¶ ¶ 2201 - 2303; and by NASD Code of Procedure for Handling Trade Practice Complaints §§ 1 - 27, NASD Manual (CCH) ¶ ¶ 3001 - 26.

At least within District No. 8, the District Business Conduct Committee is identical with the District Committee, the latter annually appointing themselves as the former. In the words of the District 8 Director, "they are, in effect, the

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4 The District Business Conduct Committee is hereinafter sometimes referred to as the "DBCC".

same Committee wearing different hats." (Dearborn Deposition at 5.)

An Examination Subcommittee of the District Business Conduct Committee reviews findings and reports from NASD field personnel, and inititates complaints against broker/dealers. The complaint is drafted by the NASD District counsel or staff and the Examination Subcommittee members who initiate such complaints subsequently can vote at the adjudication of those complaints. (Dearborn deposition, 10-11; 50).

The complaint is then heard by a hearing panel which sits as a subcommittee of the District Business Conduct Committee. The initial selection of the three panel members is made by the District Counsel, and those three members as determined by the District Counsel are formally appointed by the District Chairman. (Dearborn deposition, 14, 18-19). In addition to voting on the full DBCC, the member who initiated the complaint against the broker/dealer charged with a violation can also serve on these hearing panels. (Dearborn deposition, p. 11). The District 8 counsel who served as prosecutor in the NASD disciplinary proceedings against WACO and Mr. Prevatte herein effectively selects the hearing panel by securing three members to serve on same (subject to limited objection by

a respondent).

After drafting the Complaint, framing the charges, and unilaterally selecting the initial "jury", the District Counsel for the NASD then acts as prosecutor at said hearings, presenting the evidence against an accused broker/dealer.[5]

The identities of the adjudicative hearing panel members effectively are thus initially chosen by the NASD counsel. This is a deviation from the selection process for the administrative (as opposed to adjudicative) subcommittees of NASD District 8. The membership of administrative subcommittees is determined by rotation among the members of the full District Business Conduct Committee. [Deposition of Theodore M. Perkowski (hereinafter "Perkowski deposition"), 55]. Apparently, the discretion of the District Counsel results in frequent requests to certain members for hearing panel service.[6]

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5 See Transcript of NASD hearing in CHI - 654 and 659 as set forth in Exhibit "9" to "Plaintiff's Motion for Entry on Summary Judgment of an Order of Permanent Injunction and Brief in Support thereof." See also Shannahan Affidavit, ¶ 4, (Exhibit "7" to "Plaintiff's Brief in Support of Plaintiff's Motion for Entry on Summary Judgment of an Order of Permanent Injunction", see Appendix).

6 In Mr. Perkowski's words, "I am always getting called." Perkowski deposition, 57.

As noted hereinabove, the same NASD District counsel functions in a prosecutorial role during the hearing itself. However, the involvement of the District counsel in the hearing process did not end there, as appears more fully, infra.

The hearing panel deliberated concerning the charges against WACO and Mr. Prevatte immediately upon the closing of the evidentiary hearing on October 22, 1980. The prosecutor remained present during the deliberations of the hearing panel. (Perkowski deposition, 18; Plaintiff's Answer to Defendants' Interrogatory #17(d); Shannahan Affidavit).

The deliberations of the NASD District 8 hearing panels are further relevant to the Appellants' claims of denial of due process because of the standards (or lack thereof) employed by the hearing panel members in adjudicating charges against NASD members who are called before them. As candidly admitted by hearing panel member Perkowski, a decision is rendered based on the personal experience of the hearing panel members:[7]

> "Q. In reference to your participation on the hearing panel and subsequently in the full deliberations of the District 8 Business Conduct Committee, it is your own subjective experiences within the brokerage industry by which you judged WACO

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7 Perkowski deposition, 25.

> and Mr. Prevatte rather than any written rules or regulations of the NASD or the SEC, is that correct?
>
> A. Yes."

The hearing panel after deliberating, reaches what Mr. Perkowski called a "mutual conclusion", based on such arbitrary and standardless discretion[8]:

> "Q. These mutual conclusions, again, are based on the subjective experiences of the hearing panel members rather than the specific rules and regulations of the NASD or the SEC?
>
> A. To the best of my experience, yes."

The subcommittee hearing panel then decides on the recommendation it will make to the full District 8 Business Conduct Committtee.

According to Mr. Perkowski, the recommendation of the hearing panel is put in the form of a draft decision by the District counsel and submitted to the full District Business Conduct Committee. The District counsel (having earlier picked the panel, prosecuted the case, and been present ex parte during deliberations) prepares a draft of the ultimate decision by the District 8 Business Conduct Committee prior to is meeting (between the time that the hearing Committee

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8 Id., p. 28, Appendix.

panel meets and the time the full District Conduct Committee meets). Based upon the testimony of the NASD Committee member Perkowski, the decision in the disciplinary action apparently is then presented as a fait accompli to the full DBCC by the District Counsel.[9]

The full District 8 Conduct Committee at its meeting then relies on the District counsel/prosecutor to provide the proper language in summary of the earlier hearing testimony when the full Committee considers a case. (Perkowski deposition, p. 49). In fact, Perkowski estimates he has served in an adjudicative capacity in over eighty such hearings, and in only one was he ever asked to review transcripts. Perkowski could not recall among those eighty cases any instance where the language written or proposed by the District counsel in the counsel's draft of the decision was ever changed by the full Committee. (Ibid., 52). In his experience, the draft prepared by the District counsel is generally accepted verbatum as the final decision of the NASD District 8 Business Conduct

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[9] Perkowski deposition, p. 29. while some conflict exists as to when the draft opinions are prepared (see Dearborn deposition, p. 36-37), there is no doubt that it was authored by Shannahan. (Plaintiff's Answer to Defendants' Interrogatory #15; Dearborn deposition, pp. 36; 55-57).

Committee. (Ibid., 53-54).

Despite the reliance by the adjudicators upon such oral or written representations by the NASD prosecutor concerning the hearing panel testimony, a broker/dealer charged with an offense or his counsel does not possess the opportunity to address those who will render the final NASD District 8 adjudication of his guilt or innocence, or even be present at such DBCC proceedings. (Ibid., at 54; Dearborn deposition at 49).

Even though the accused is thus barred from participation, the District counsel and staff involve themselves in ex parte participation in the deliberations of the full District 8 Business Conduct Committee. As described by Mr. Perkowski (deposition at 33-34):

> "A. . . . But in my recollection the complaint is read by the staff attorney to the full Business District Conduct Committee. The Chairman of the Business Conduct Committee asks for comments from the hearing Committe and then asks for general discussion from the full Business Conduct Committee.
>
> Q. Does the District counsel, Ms. Shannahan, or Mr. Dearborn, or the other members of the staff participate in asking questions or answering questions or making comments at this point?
>
> A. In my experience their function at this point is strictly for information purposes where the Committee might need additional information

or material facts.

Q. So if requested, they do provide information about material facts at that stage of the hearing, at that stage of the proceedings?

A. Yes.

Q. And the stage of the proceedings to which I am making reference is the meeting of the full District Conduct Committee.

A. Yes. I assumed you meant that." (Emphasis supplied).

Despite such ex parte provision of what Perkowski described as "additional information or material facts" outside the presence of a respondent or his counsel, it is not clear whether the respondent's testimony at the hearing panel is even available to the full District 8 Business Conduct Committee. District Director Dearborn did not recall whether or not the WACO hearing panel transcript was even filed before the DBCC met and made its decision. (Dearborn deposition, 38.)

It was the outcome of such a process upon which the SEC based its District Court case against Mr. Prevatte and WACO Financial, Inc.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW INVOLVES IMPORTANT QUESTIONS OF CONSTITUTIONAL LAW RELATING TO THE APPLICATION OF THE FIFTH AMENDMENT

OF THE CONSTITUTION OF THE UNITED STATES TO ADMINISTRATIVE ADJUDICATIVE PROCEEDINGS.

As the role of administrative forums has grown in the governmental adjudication of disputes directly affecting the rights of private parties, replacing or supplanting judicial forums, clearly defined delineation from this Court of the constitutional safeguards applicable to such administrative adjudications is of grave importance. Granting the requested writ permits this Court to clearly enunicate the practical application to administrative tribunals of the constitutional standards of due process.

In the securities industry, 15 U.S.C. §78o-3(b)(a) requires the NASD to "provide a fair procedure for the disciplining of members". Lower appellate courts have made it clear that the disciplinary proceedings of self-regulatory bodies such as the NASD under the Maloney Act and the Securities Exchange Act of 1934 give the NASD quasi-governmental powers so intimately involved with the Plaintiff Securities and Exchange Commission as to be within the purview of the Fifth Amendment controls over governmental due process. Intercontinental Industries, Inc. v. American Stock Exchange and Securities and Exchange Commission, 452 F. 2d 935 (5th Cir., 1971).

Procedural due process has been construed to include

the right to a hearing before impartial adjudicators who are also selected by impartial individuals. As one lower Court which confronted the issue has observed:

> "Certainly, one prerequisite of a due process hearing is that the members of the Trial Board and presumably the persons bringing the charges and selecting the Board are impartial." Boulware v. Battaglia, 344 F. Supp. 889, at 907 (D.C. Del., 1972).

From beginning until end, the NASD disciplinary proceedings fail to accord due process to those who are called to answer charges before it.[10]

As noted in a scholarly article describing this process:

> "The staff's involvement with the disciplinary hearing, however, is not limited to prosecuting the case. For example, after the facts are presented to the DBCC, members of the DBCC periodically seek ex parte advice from the staff on such matters as procedure, case precedent, and the application

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10 In this instance, the selection of hearing panel was far removed from impartiality. The NASD District 8 counsel, who functions as the prosecutor during the adversary hearing before the panel selected, initially determines the composition of the hearing panel. In effect, the NASD District 8 prosecutor is given the right to "forum shop" for the hearing panel or given defacto unilateral jury strikes. (It is particularly instructive, as noted above, that other District 8 subcommittees are selected by rotation, rather than staff discretion.) The unfairness of this procedure to respondent broker/dealers is discussed at length in the article, "A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD", 64 Cornell Law Review, 374, at 381-384 (1979).

> of the NASD's rules. Moreover, after the DBCC arrives at its decision, the district director memorializes the DBCC's decision in a written opinion setting out the facts and legal basis for the decision. The extent of the staff's participation in the complaint and decision making process raises the issue as to whether there is an impermissible commingling of prosecutory and adjudicatory functions at this level." ("NASD Disciplinary Proceedings: Practice and Procedure", The Business Lawyer, Vol. 37 no. 3, April, 1982).

The NASD District Counsel (having already determined the hearing panel, and prosecuted the case in the adversary evidentiary hearing) is then present during the hearing panel's deliberations, along with other NASD staff members. (Plaintiff's Answers to Defendants' Interrogatory No. 17a, p. 14).

The same NASD attorney then prepares the draft decision prior to its making by the full NASD District Business Conduct Committee, and the prosecutor and staff provide what DBCC member Perkowski described as "additional information or material facts" before the full DBCC during its consideration of the hearing panel's report.

Other lower Federal Courts have held that ex parte communications to a decision-maker by an adversary party in an adjudicatory proceeding are prohibited as fundamentally at variance with established conceptions of due process. See Sangamon Valley Television Corp. v. United States, 269 F.

2d 221 (D.C. Cir., 1959); see also Administrative Procedure Act §5(c), 5 U.S.C. §554(d); and see Stein v. Mutuel Clerks Guild of Massachusetts, Inc., 384 F. Supp. 444 (1974) - Aff'd 560 F. 2d 486[11].

Administrative adjudications effectively can have the same impact upon the litigants as judicial proceedings. As earlier noted by the Sixth Circuit:

> " '[A]n administrative hearing of such importance and vast potential consequences must be attended, not only with every element of fairness but with the very appearance of complete fairness. Only thus can the tribunal conducting a quasi-adjudicatory proceeding meet the basic requirement of due process.' " American Cyanamid Company v. F.T.C., 363 F. 2d 757 (6th Cir., 1966).

The application of due process standards to administrative adjudicatory conduct has been subject to differing treatment

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11 "While lay proceedings can not be held to the due process standards required in a court of law, it offends notions of fundamental fairness to have the prosecutor present and taking an active part in the deliberations of any fact-finding tribunal. Regardless of how limited his role or how noble his purpose, such a practice permits the possibility of a prosecutor characterizing the evidence presented, or substituting his recollection for that of the hearing officers. It goes without saying that a prosecutor with less than noble motives might subvert such a practice into an occasion for presenting additional evidence, without there being any opportunity for rebuttal by those involved. Finally, but not at all unimportant, is that anyone subject to such a practice could hardly be blamed for doubting that he had been treated fairly and impartially.

by various American courts.

In Matter of Robson, 575 P. 2d 771 (1978), the Supreme Court of Alaska considered a challenge to the proceedings of the Disciplinary Board of the Alaska Bar Association. As in this case, the counsel for the professional self-regulatory organization had prosecuted the case against Respondent before the adjudicatory panel in the prosecution stage of the grievance proceedings, and then his superior was present during the deliberations of the panel. As in the case at bar, it was vigorously argued that the staff member's presence during the deliberations was limited to a ministerial function, including the recording of memoranda from which the subsequent decision of the panel could be drafted. (Matter of Robson, supra at 773 - 775). Nevertheless, the Court ruled that "the proceedinggs violated due process as to the fact or appearance of impartiality during the deliberations of the Disciplinary Board", and stated:

> "We hold that to assure both the fact and appearance of impartiality in the Disciplinary Board's decisional function, counsel associated with either the prosecution or defense should not be present during deliberations."

The Court reasoned:

> "When an administrative official has participated in the past in any advocacy capacity against the party in question, fundamental fairness is normally held to require that the former advocate take no

> part in rendering the decision. The purpose of this due process requirement is to prevent a person with probable partiality from influencing the other decision-makers."

The case at bar presents an even more egregious denial of due process than was present in Robson. In Robson, a due process violation was found to have occurred of such magnitude as to invalidate the proceedings where the Director of the professional organization was present during the deliberations, even though the actual prosecution of the case was conducted by an assistant attorney under the Director's general supervision and guidance. In this instance, the NASD prosecutor was personally present in both phases of the proceedings, in addition to the presence of NASD District Director Craig Dearborn, the prosecutor's supervisor.

In Newell v. State, 620 P. 2d 680 (1980), the Supreme Court of Alaska amplified its reasoning from Robson, supra, in an administrative adjudication marred by the presence of the executive director of the appropriate administrative body during the hearing panel's deliberations. The Court concluded that the presence of such staff personnel similarly invalidated the subject proceedings:

> "As noted, the bar executive director in Robson had not directly prosecuted the bar's case, but her position as the prosecuting attorney's supervisor

> gave the deliberation an appearance of partiality. In our opinion a far stronger appearance of partiality is created when the persons sitting in on deliberations is the person who initially recommended revocation and whose reports and testimony form the bulk of the evidence supporting revocation. We can not realistically regard such a person as other than part of the prosecution." Id., at 682. (Emphasis supplied.)

In this case, all of the prosecution's testimony at the hearing were from NASD staff examiners and those under the authority of the District Director in question. The taint upon the proceedings from his status as a part of the prosecution can not be removed simply because the investigations were made vicariously through those he supervised in the performance of his duties as District Director in "the oversight and general supervision of disciplinary procedures" within his District. (Dearborn deposition at 4).

As noted hereinabove, the decision of the NASD District Business Conduct Committee for District No. 8 was authored by the NASD prosecutor. Plaintiff's Answer to Defendants' Interrogatory #15, at 10. (Docket Entry #31, January 25, 1982); Shannahan Affidavit, supra at p. 12.)

The decision's authorship by the NASD District counsel constitutes a further deprivation of Defendants' due process rights, particularly in light of the said attorney's presence

and prior involvement in the adjudicative deliberations.

As noted in Matter of Robson, supra at p. 775:

"The determination of findings and recommendations are the essence of the judicial function of the Disciplinary Board. The preferable method of handling those tasks is for the Board to reach its decision after deliberations held without the presence of counsel associated with either side. As in a Court case, the Board may then indicate to both sides its general findings and recommendations and, if it so desires, request one of the participating attorneys to prepare a draft thereof."

As one commentator has noted[12]:

"After the hearing has been completed, the panel must render its decision. Although it is the panel which deliberates and concludes, it is the prosecutor at the NASD who actually writes the panel's opinion. A number of undesirable consequences follow from this procedure. First, the panel avoids an important facet of the intellectual discipline essential to a reasoned decision. Judges often make determinations immediately after a hearing on the merits and then modify their initial determinations in the course of writing their opinions. The process of careful reasoning required to draft an opinion is a substantial factor in achieving a fair and just result. In certain instances, it will represent a substantial safeguard for the rights of the Defendant. It diminishes the role that whim, prejudice, emotion and intellectual laziness play in reaching a conclusion. Second, the content of the panel's written opinion may have important ramifications for the Defendant."

Among these ramifications, Lowenfels notes that appellate

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12 Lowenfels, "A Lack of Fair Procedures In The Administrative Process: Disciplinary Proceedings at the Stock Exchanges And The NASD", supra at 389.

tribunals are inevitably influenced in great part by the reasoning and language of the opinion of the initial panel:

> "A crucial word placed in a strategic position, a premise leading to a vital conclusion, the omission of an important counterargument, the entire structure of reasoning and organization which supports the initial decision - any of these factors may play a crucial role in an appellate decision. And, at the NASD, all of these factors are controlled by the prosecutor when he composes the initial panel's opinion." Id., p. 390.

The NASD and its personnel proudly flaunt the fact that "the NASD's disciplinary hearings are not conducted in formal fashion as in a Court of law . . ." NASD Disciplinary Procedures publication, p. 5 (exhibit to Dearborn deposition).

As stated at the NASD hearing in a comment by the Chairman[13], "we do not try to conform with technical or legalistic procedures such as might be used in the Courts."

Unfortunately, for the Petitioners herein, such informality degenerated into proceedings wherein a decision was rendered based upon the subjective experiences of the hearing panel rather than objective legal criteria.

As expressed by Mr. Perkowski, a decision is rendered "in the light of my experience in the industry as opposed to a decision that might be rendered in a Court of law by a judge

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13 Transcript of NASD hearing, Plaintiff's Brief, Exhibit "9", p. 2 (Docket sheet #16, August 21, 1981.)

or jury who may not have the expertise in the particulary industry." Perkowski deposition, p. 23.

Perkowski admitted that such experiences might vary from individual to individual within the industry, but that such personal experiences form the standard by which a Respondent is judge. Hence, by the explicit admission of one of the adjudicators, it is "subjective experiences within the brokerage industry" rather than "any written rules or regulations of the NASD or the SEC" by which WACO and Mr. Prevatte were judged in the deliberations of the hearing panel and the full District 8 Business Conduct Committee. (Id., at 25).

A "mutual conclusion" is made by the adjudicators "based on the subjective experiences of the hearing panel members rather than the specific rules and regulations of the NASD or the SEC." (Id., at 28).

The administrative adjudication of cases based upon arbitrary and variable subjective criteria, rather than objective standards, deprives litigants of due process of law, and renders such adjudications invalid. 16A Am Jur 2d CONSTITUTIONAL LAW § 816.

Moreover, in this case, the District Business Conduct Committee initiated both of the complaints (CHI No. 654 and

CHI No. 659) which resulted in the ultimate snactions imposed by Petitioners herein. CHI 654 was signed for the Committee by DBCC member Michael J. Wyvill, and the complaint in CHI 659 was signed by DBCC member Richard C. Romano.[14] Both Romano and Wyvill subsequently participated in the DBCC disciplinary proceedings against Defendants. Such dual participation in both the issuance of the complaint and the subsequent adjudication is consistent with the general practice of the NASD. [Plaintiff's Answer to Defendants' Interrogatory #13, at 9, (see Appendix); Dearborn deposition, p. 10-12; Perkowski deposition, at 14].

This Court has earlier held that due process of law requires that an adjudicative hearing be conducted by some person or body other than the one initially dealing with the case. (Goldberg v. Kelly, 397 U.S. 254, 266, 271 (1970). Those involved in making such recommendations and bringing such charges can not always have complete objectivity in evaluating them, and due process requires a separate adjudicator. Morrissey v. Brewer, 408 U.S. 471, 485-86 (1972).

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14 Complaint CHI No. 654, Exhibit "1" to Dearborn Affidavit (which is Exhibit "6" to Plaintiff's Brief. Complaint CHI No. 659, is Exhibit "4" to said Affidavit.) See Appendix.

Hence, granting the writ herein requested would permit the Court to address the following components of due process in administrative adjudications:

> 1.) May an administrative agency's attorney commingle prosecutorial function, unilateral selection of hearing panel members, ex parte participation in the deliberations of the administrative adjudicatory body, and legal responsibility for the authorship of ajudication decision?
>
> 2.) May "subjective experiences" rather than written rules or regulations constitute the decisional criteria of administrative adjudicators?
>
> 3.) May an administrative complainant also subsequently serve as an adjudicator in the same action?

The requested writ should be granted to clarify these important recurring questions of constitutional law and their application to administrative adjudications.

II. THE WRIT SHOULD BE GRANTED TO CONSIDER WHETHER CONSTITUTIONAL DEFICIENCIES IN AN ADMINISTRATIVE AGENCY'S PROCEDURE MAY BE COLLATERALLY ASSERTED IN SUBSEQUENT JUDICIAL PROCEEDINGS.

The United States Court of Appeals for the Sixth Circuit held below that the Petitioner's failure to pursue review of the NASD action by administrative appeal to the SEC precludes a defense in a subsequent District Court judicial enforcement action asserting the unconstitutionality of the administrative

proceedings upon which the enforcement action is premised.

The SEC successfully below evaded the constitutional defenses raised by WACO and Mr. Prevatte based upon their alleged failure to administratively challenge the constitutionality of the administrative scheme of broker/dealer discipline. The Petitioners claimed that administrative agencies cannot adjudicate constitutional issues, and that administrative forums are not the proper place for adjudication of constitutional claims, citing Califano v. Sanders, 430 U.S. 99 109:

> "Constitutional questions obviously are unsuited to resolution in administrative hearing procedures and, therefore, access to the court is essential to the decision of such questions . . ."

This Court also noted in Johnson v. Robison, 415 U.S. 361, 368 (1974) that adjudication of the constitutionality of congressional enactments has generally been thought beyond the jurisdiction of administrative agencies. Constitutional questions may only be properly answered in a judicial forum. See also Abbott Laboratories v. Gardiner, 387 U.S. 153 (1967).

In earlier litigation commenced by the Petitioners herein in which the District Court declined to consider allegations of unconstitutionality when raised as a sword by WACO and Mr. Prevatte as Plaintiffs, the District Court cited WACO's failure to exhaust administrative remedies prior to invoking

District Court jurisdiction as precluding a judicial offensive by WACO and Mr. Prevatte.[15] In this present litigation, however, it is the SEC who has in this action elected to invoke the jurisdiction of the District Court. WACO and Prevatte contend that they may quite properly assert their constitutional claims as a shield from such attack.

Petitioners contend that the doctrine of exhaustion of administrative remedies is inapplicable in judicial enforcement proceedings commenced by a governmental agency. Lichter v. United States, 334 U.S. 742, 774; see also United States v. McCrillis, 200 F. 2d 884 (1st Cir.); West v. Bergland, 611 F. 2d 710 (8th Cir., 1979); Reynolds v. Dukakis, 441 F. Supp. 646 (D.C. Mass, 1979). As summarized in 2 Am. Jur. 2d Administrative Law § 599:

> "However, in regard to enforcement proceedings it has been held that a defense of unconstitutionality of the statute providing the administrative procedure is not precluded by failure to exhaust appeal procedures, and that where the jurisdiction of the Court has not been withdrawn by statute, the doctrine of exhaustion of administrative remedies is wholly misapplied when invoked against one not seeking equitable relief but merely defending himself against a regulation or order asserted to be invalid."

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15 WACO Financial, Inc., and J. Jerome Prevatte v. NASD and SEC, 513 F. Supp. 758 (W.D. Mich., 1981).

The Petitioners in this action did not ask for equitable injunctive relief. Rather, they merely sought to defend themselves against statutes, regulations and orders asserted to be invalid. It is the SEC who brought this action for equitable relief, and WACO and Mr. Prevatte sought only to raise a defense of unconstitutionality in defending themselves against the government's claims.

The election to enter the District Court forum was made not by WACO and Mr. Prevatte, but rather by the SEC. The constitutional claims WACO and Mr. Prevatte have previously sought to utilize as a sword to obtain injunctive relief are now relied on as a shield from the harm which has been visited upon them by the injunctive relief obtained by the SEC.

The appellate court below narrowly construed the limitation on administrative jurisdiction to adjudicate constitutional issues to apply only to the constitutionality of a congressional enactment, and is not applicable to the agency's procedures in administering the enactment. However, such a restricted view artificially circumvents the real issue. It is not the object measured which is the arbiter of administrative jurisdiction (and here the determinant of the applicability of exhaustion requirements). Rather, it is the

competency to utilize and apply constitutional standards which is within the sole and zealously guarded purview of the judiciary.

Granting the requested writ would allow this Court to determine whether the jurisprudential act of determining the constitutional propriety of any governmental activity (both procedural or substantive) is within the exclusive ambit of the judiciary.

III. GRANTING THE REQUESTED WRIT WOULD ALLOW CONSIDERATION OF A RECURRING QUESTION OF FEDERAL CIVIL PROCEDURE RELATING TO THE CORRECTION OF DEPOSITION TESTIMONY.

On January 27, 1982 in Chicago, Illinois, counsel for WACO and Mr. Prevatte, pursuant to notice and subpoena took the deposition of Theodore M. Perkowski. Mr. Perkowski is not a party to this action, but was a member of the District Conduct Committee and the District Committee of District 8 of the National Association of Securities Dealers.

Following the close of discovery in this case, the deponent Perkowski filed an "Errata Statement" supplementing his deposition, and contradicting some of the substantive responses therein. Said Statement went far beyond a correction of alleged

typographic or stenographic errors in the deposition transcript[16], and purported to supplement the deponent's testimony in a self-serving fashion, directly contradicting key clear and unambiguous responses previously made by the deponent in his sworn deposition testimony.

Inter alia, the Perkowski Errata Sheet directly contradicts the deponent's earlier testimony concerning the role of the NASD prosecutor and District Director in NASD deliberations (Perkowski deposition, 33; Perkowski Errata Sheet, p. 2-3), and the standards by which the NASD disciplinary adjudications are made. (Perkowski deposition, 24, 25, 28, 34; Perkowski Errata Sheet, 1-2).

FRCP 32(4) provides that a motion to suppress the deposition or some part thereof may be brought to correct errors and irregularities in the completion and return of a deposition.

WACO and Prevatte accordingly moved to strike or suppress said Errata Sheet, or in the alternative to reopen the deposition of Perkowski at Plaintiff's expense. (March

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16 Contrast with the "Errata Statement" of E. Craig Dearborn, Phillip M. Petraitis and that of Donald D. Watson, which limit themselves to a correction of stenographic mistakes or omissions in those deposition transcripts.

11, 1982, Docket Entry #42). The Court allowed an additional thirty days for the deponent to be re-deposed, but required that same be done at the Defendants' own expense.[17] (April 14, 1982 Order, Docket Entry #44, see Appendix).

The Errata Sheet which the Court allowed Perkowski to make part of his deposition fails to conform with FRCP 30(e). FRCP 30(e) provides that "any changes in form or substance which the witness desires to make shall be made before the officer before whom the deposition was taken."

In Erstad v. Curtis Bay Towing Co., 28 F.R.D. 583 (D.C. Md., 1961), the Court therein indicated that deposing counsel has a further right to be present at the time the allged errors are corrected by the deponent. But see, Allen & Company v. Occidental Petroleum Corporation, 49 F.R.D. 337, at 340 (S.D. N.Y., 1970).

Authority exists for the proposition that a deponent is not permitted under Rule 30(e) to subsequently make substantive changes in a completed deposition. Rule 30(e) contemplates an examination which is finished, except for immaterial corrections. Such should have been the District

17 The expense was already great in the first deposition, with the deposition taken in Chicago, Illinois and Prevatte and his counsel travelling from Kalamazoo, Michigan and Louisville, Kentucky respectively.

Court's ruling herein.

As stated in De Severski v. Republic Aviation Corporation, 2 F.R.D. 113, 115 (D.C. N.Y.):

> "Rule 30, Subdivision (e), contemplates a finished examination, an examination that is concededly finished except for certain errors and mistakes on immaterial matters. Such examination should not be considered finished if a witness seeks to recant his testimony or feels that to be 'truthful' he must directly contradict the answers already given by him on most material points. To do otherwise is not only to create delay but make complex procedure which the very purpose of the Rule is to avoid."

This interpretation has been accepted by other courts as well. Purchan v. Bailey Meter Company, 21 F.R.D. 232 (D.C. Del., 1957); see Downing v. Gasser, 90 A. 2d 651.

An alternative view of FRCP 30(e) holds that a deponent may make changes, even changes of a substantive nature, but that both the original and amended answers shall stand of record. If (as in this case) the changes are of such an extent as to materially alter the testimony given by the deponent, the deposition should have been deemed by the District Court to have been incomplete, and WACO's counsel should have been given the right to further examine the deponent. Colin v. Thompson, 16 F.R.D. 194 (D.C., Mo., 1954); Sauder Industries, Inc. v. Carborundum Co. v. Alaska Interstate Co., 31 Federal

Rules Service 2d 437 (D.C. Ohio, 1980); Cf., Allen & Company v. Occidental Petroleum Corporation, supra.

In the Sauder case, the Court directly stated with particular applicability to this case:

> "Further, if the changes are of such an extent as to materially alter the testimony given by the deponent the deposition will be deemed as incomplete and the interrogating party given the right to further examine the deponent." Sauder Industries, Inc. v. Carborundum Co. v. Alaska Interstate Co., supra at 441.

Where such additional examination is necessary because of the substantive nature of the changes made by the deponent, the additional reporting and transcription costs, and the attorney fees of the party originally taking the deposition, should be paid by the deponent or the adverse party. Colin v. Thompson, supra.

In Lugtig v. Thomas, 89 F.R.D. 639, at 642 (N.D. Ill, 1981); the Court specifically held:

> "Furthermore, if changes made in the deposition pursuant to Rule 30(e) make the deposition incomplete or useless without further testimony, the party who took the deposition can reopen the examination. (Citations omitted). Deposing counsel can ask questions which were made necessary by the changed answers, questions about the reasons the changes were made, and questions about where the changes originated, whether with the deponent or with his attorney. (Citation omitted) . . . Since it it Defendant's actions which necessitate reopening

> the examination of Defendant, the costs and attorney fees connected with the continued deposition will be borne by Defendant. (Citing Colin v. Thompson, supra)"

The deponent Perkowski went far beyond mere immaterial or typographic corrections in his deposition transcript. Instead he made substantive additions to his testimony, or directly contradicted his earlier sworn statements. Furthermore, he did so in a manner not sanctioned by FRCP 30(e). The Perkwoski Errata Statement should accordingly have been suppressed or striken pursuant to FRCP 32(d)(4) and it should not have been deemed as evidence in this case for any purpose pursuant to FRCP 32(b).

CONCLUSION

For the foregoing reasons, a writ of certiorari should be issued to review the judgment and opinion of the United States Sixth Circuit Court of Appeals.

RESPECTFULLY SUBMITTED,

BY: _____

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CERTIFICATE

I, Theodore H. Amshoff, Jr., attorney at law, and counsel for Petitioners/Appellants WACO Financial, Inc., and J. Jerome Prevatte, hereby certify that I caused three (3) true and correct copies of the Petition for Writ of Certiorari to be served by first class mail, postage prepaid, on Wednesday, April 3, 1985, upon the following counsel at the following address:

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_____
THEODORE H. AMSHOFF, JR.

APPENDIX

RECOMMENDED FOR FULL TEXT PUBLICATION
Sec, Sixth Circuit Rule 24

No. 83-1309

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION, *Plaintiff-Appellee,* v. WACO FINANCIAL, INC. and J. JEROME PREVATTE, *Defendants-Appellants.*	ON APPEAL from the United States District Court for the Western District of Michigan.

Decided and Filed January 3, 1985

Before: LIVELY, Chief Judge; MERRITT, Circuit Judge; and GIBSON, Senior Circuit Judge.*

LIVELY, Chief Judge. The defendants appeal from a judgment of the district court which permanently enjoined WACO Financial, Inc. (WACO) and its president and chief stockholder, J. Jerome Prevatte (Prevatte), from dealing in securities in violation of federal securities laws. On appeal the defendants contend that the procedures by which they were

* The Honorable Floyd Gibson, Senior Circuit Judge, United States Court of Appeals for the Eighth Circuit, sitting by designation.

barred from engaging in securities trading as a broker-dealer and principal violated rights guaranteed them by the due process clause of the Fifth Amendment.

I.

Under the Securities Exchange Act[1] regulatory responsibility for the securities business is shared by the Securities and Exchange Commission (SEC) and the securities industry. The securities industry is self-regulated to a point, with ultimate authority resting with the SEC. The industry group responsible for regulation of trading in over-the-counter markets is the National Association of Securities Dealers (NASD). Broker-dealers who engage in over-the-counter trading and who belong to the NASD are required to abide by NASD Rules of Fair Practice and to meet other NASD requirements. The NASD exercises disciplinary powers over its members and by statute is required to enforce compliance with securities laws and NASD rules and regulations. A disciplinary action which results in the suspension or expulsion of a broker-dealer from the NASD for conduct inconsistent with just and equitable principles of trade disqualifies that broker-dealer from trading in securities. 15 U.S.C. § 78(o)(b)(7) (1982); 17 C.F.R. § 240.1568-2(a) (1984). Disciplinary actions of NASD are subject to review by the SEC and a United States Court of Appeals. 15 U.S.C. § 78y(a)(1).

WACO was organized as a securities broker-dealer in 1975 and, after several applications for membership in the NASD had been rejected for failure to meet various standards, was accepted for NASD membership in 1978. Several NASD staff examinations of WACO in the ensuing months revealed instances of failure to meet special customer reserve account requirements, failure to maintain required net capital levels

[1] The Securities Exchange Act of 1934, codified at 15 U.S.C. § 78 (1982).

and failure to abide by other rules and regulations of the NASD and the SEC. Though WACO voluntarily suspended business in May 1980 in order to bring its records and reports into compliance with requirements, shortly after it resumed business the following month its records were found again to be incomplete and out of compliance.

Following established procedures a district committee of NASD issued two complaints against WACO and Prevatte. A hearing was held on the complaints and the district committee issued a decision censuring WACO and Prevatte, expelling WACO from NASD and barring Prevatte from associating in a principal capacity with any NASD member. This decision was based on findings of such "gross negligence" by WACO as to render its remaining in business "a deceptive and fraudulent device" and a "total disregard" by Prevatte of the responsibilities of a financial principal. On appeal by WACO and Prevatte the NASD's Board of Governors affirmed the decision of the committee. The membership of WACO in NASD was terminated and the effect of this action was to disqualify WACO from engaging in the securities business.

WACO and Prevatte appealed the decision of the Board of Governors to the SEC with a request to stay enforcement, and while that appeal was pending they filed suit against the NASD and the SEC in district court, seeking an injunction and a declaratory judgment that the disciplinary action by the NASD was unconstitutional. The district court found that WACO and Prevatte had not exhausted available administrative remedies and dismissed the complaint. *WACO Financial, Inc.* v. *NASD*, 513 F. Supp. 758 (W.D. Mich. 1981). WACO and Prevatte did not appeal the judgment of the district court. Meanwhile the SEC denied their motion for stay of sanctions and WACO and Prevatte filed a petition in this court seeking a stay and review of that commission action denying the stay. At this time the SEC had not reviewed the NASD disciplinary action. This court denied the petition for stay and dismissed

the petition for review upon finding that the petitioners had not exhausted available administrative remedies and had failed to show entitlement to a stay. *WACO Financial, Inc. v. SEC and NASD*, 6th Cir. No. 81-3282 (unpublished order July 9, 1981).

The SEC later dismissed the defendants' application for for review of the NASD Board of Governors' decision when WACO and Prevatte failed to file a brief or statement in support of their position. WACO and Prevatte did not seek review of the final order of the SEC in this Court or the Court of Appeals of the District of Columbia as permitted by 15 U.S.C. § 78y(a)(1). However, when WACO and Prevatte continued to engage in the securities business, the SEC brought an action in the United States District Court for the Western District of Michigan seeking an injunction against continuation of this conduct by WACO and Prevatte. The district court granted a preliminary injunction, *SEC v. WACO Financial, Inc.*, 518 F.Supp. 651 (1981). After further proceedings, including discovery, the district court granted the SEC's motion for summary judgment and entered the permanent injunction from which this appeal is taken.

II.

As they did in the district court, WACO and Prevatte argue here that there was such a commingling of prosecutorial and adjudicatory functions during the proceedings before the NASD district committee and Board of Governors that they were denied due process. Counsel for WACO and Prevatte was questioned at oral argument as to why this issue had not been preserved for review during the NASD proceedings and then raised before the SEC. The response was that the SEC has no authority to decide constitutional questions. The same position was set forth in the appellants' reply brief, where *Califano v. Sanders*, 430 U.S. 99 (1977), and *Johnson v. Robison*, 415 U.S. 361 (1974), were cited for support.

The cited decisions do not support the argument. With respect to the question in this case, the Court in *Califano v. Sanders*, merely reiterated "the well-established principle that when constitutional questions are in issue, the availability of judicial review is presumed . . . ." 430 U.S. at 109. With respect to proceedings before the SEC, no presumption is required. Since the Securities Exchange Act explicitly provides for judicial review of final orders of the SEC in disciplinary actions, this "well-established principle" is satisfied. By preserving the issue before the NASD bodies and the SEC the appellants could have obtained direct judicial review of their constitutional claims following all administrative steps. They chose, instead, to attempt to litigate these issues as a defense to a subsequent district court enforcement action.

The language from *Johnson v. Robison* relied upon by the appellants likewise has no application to the present case. Justice Brennan quoted with approval from an administrative decision that "[a]djudication of the constitutionality of congressional enactments has generally been thought beyond the jurisdiction of administrative agencies." 415 U.S. at 368. The issue which WACO and Prevatte sought to raise has nothing to do with the constitutionality of a congressional enactment. They question the constitutionality of procedures followed by an agency and its delegate. They did not question the constitutionality of the Securities Exchange Act. They attacked procedures permitted by the SEC in administering this Act. These questions should have been raised in the administrative proceedings. The quoted language from *Johnson v. Robison*, does not reach the present case.

III.

As we have indicated, the appellants WACO and Prevatte have mounted a collateral attack in this action on a final order of the SEC which they failed to appeal directly by seeking review pursuant to § 78y. This collateral attack by way of de-

fense to the enforcement action is not permitted. Even if they had come to this court properly, that is by a petition to review the final order of the SEC, the issues which they seek to raise would not have been properly before this court because they were not raised before the SEC. On petition to review a final disciplinary order of the SEC, this court does not review actions of the NASD. Those actions are fully reviewed by the SEC and it is the final order of that public body which is reviewed by the court of appeals. The SEC should have an opportunity to correct any deficiencies in the NASD proceedings before issuing its final order. Since the charge of commingling of prosecutorial and adjudicatory functions was not raised before the SEC, it cannot be considered by this court in the absence of a showing of some reasonable ground for not raising it before the Commission. *Shultz* v. *SEC*, 614 F.2d 561, 569 (7th Cir 1980). WACO and Prevatte have presented no reasonable grounds for failing to raise the issue before the SEC.

The judgment of the district court is affirmed.

SECURITIES EXCHANGES **15 USCS § 78o**

§ 78*o*. Registration and regulation of brokers and dealers

(a) Registration of all persons utilizing exchange facilities to effect transactions; exemptions. (1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

(2) The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order.

(b) **Manner of registration of brokers and dealers.** (1) A broker or dealer may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such broker or dealer and any persons associated with such broker or dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Commission shall—

(A) by order grant registration, or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings, the Commission, by order, shall grant or deny such registration. The Commission may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant such registration if the Commission finds that the requirements of this section are satisfied. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under paragraph (4) of this subsection.

(2)(A) An application for registration of a broker or dealer to be formed or organized may be made by a broker or dealer to which the broker or dealer to be formed or organized is to be the successor. Such application, in such form as the Commission, by rule, may prescribe, shall contain such information and documents concerning the applicant, the successor, and any persons associated with the applicant or the successor, as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The grant or denial of registration to such an applicant shall be in accordance with the procedures set forth in paragraph (1) of this subsection. If the Commission grants such registration, the registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt the application for registration as its own.

(B) Any person who is a broker or dealer solely by reason of acting as a municipal securities dealer or municipal securities broker, who so acts through a separately identifiable department or division, and who so acted in such a manner on the date of enactment of the Securities

Acts Amendments of 1975 [enacted June 4, 1975], may, in accordance with such terms and conditions as the Commission, by rule, prescribes as necessary and appropriate in the public interest and for the protection of investors, register such separately identifiable department or division in accordance with this subsection. If any such department or division is so registered, the department or division and not such person himself shall be the broker or dealer for purposes of this title.

(C) Within six months of the date of the granting of registration to a broker or dealer, the Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange of which such broker or dealer is a member, shall conduct an inspection of the broker or dealer to determine whether it is operating in conformity with the provisions of this title and the rules and regulations thereunder: Provided, however, That the Commission may delay such inspection of any class of brokers or dealers for a period not to exceed six months.

(3) Any provision of this title (other than section 5 [15 USCS § 78e] and subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any registered broker or dealer or any person acting on behalf of such a broker or dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor which the Commission finds—

(i) involves the purchase or sale of any security, the taking of a

false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, or fiduciary;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities; or

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of title 18, United States Code [18 USCS §§ 152, 1341, 1342, or 1343 or 471 et seq. or 1001 et seq.].

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933 [15 USCS §§ 77a et seq.], the Investment Advisers Act of 1940 [15 USCS §§ 80b-1 et seq.], the Investment Company Act of 1940 [15 USCS §§ 80a-1 et seq.], this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933 [15 USCS §§ 77a et seq.], the Investment Advisers Act of 1940 [15 USCS §§ 80b-1 et seq.], the Investment Company Act of 1940 [15 USCS §§ 80a-1 et seq.], this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(F) is subject to an order of the Commission entered pursuant to paragraph (6) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer.

(5) Pending final determination whether any registration under this subsection shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any registered broker or dealer may, upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker or dealer is no longer in existence or has ceased to do business as a broker or dealer, the Commission, by order, shall cancel the registration of such broker or dealer.

(6) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a broker or dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a broker or dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of this subsection, has been convicted of any offense specified in subparagraph (B) of said paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of said paragraph (4). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with a broker or dealer is in effect willfully to become, or to be, associated with a broker or dealer without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care should have known, of such order.

(7) No registered broker or dealer shall effect any transaction in, or induce the purchase or sale of, any security unless such broker or dealer meets such standards of operational capability and such broker or dealer and all natural persons associated with such broker or dealer meet such standards of training, experience, competence, and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors. The Commission shall establish such standards by rules and regulations, which may—

(A) specify that all or any portion of such standards shall be

applicable to any class of brokers and dealers and persons associated with brokers and dealers;

(B) require persons in any such class to pass tests prescribed in accordance with such rules and regulations, which tests shall, with respect to any class of partners, officers, or supervisory employees (which latter term may be defined by the Commission's rules and regulations and as so defined shall include branch managers of brokers or dealers) engaged in the management of the broker or dealer, include questions relating to bookkeeping, accounting, internal control over cash and securities, supervision of employees, maintenance of records, and other appropriate matters; and

(C) provide that persons in any such class other than brokers and dealers and partners, officers, and supervisory employees of brokers or dealers, may be qualified solely on the basis of compliance with such standards of training and such other qualifications as the Commission finds appropriate.

The Commission, by rule, may prescribe reasonable fees and charges to defray its costs in carrying out this paragraph, including, but not limited to, fees for any test administered by it or under its direction. The Commission may cooperate with registered securities associations and national securities exchanges in devising and administering tests and may require registered brokers and dealers and persons associated with such brokers and dealers to pass tests administered by or on behalf of any such association or exchange and to pay such association or exchange reasonable fees or charges to defray the costs incurred by such association or exchange in administering such tests.

(8) It shall be unlawful for any broker or dealer required to register pursuant to this title to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to section 15A of this title [15 USCS § 78*o*-3] or effects transactions in securities solely on a national securities exchange of which it is a member.

§ 78*o* -3. Registered securities associations

(a) Registration; application. An association of brokers and dealers may be registered as a national securities association pursuant to subsection (b), or as an affiliated securities association pursuant to subsection (d), under the terms and conditions hereinafter provided in this section and in accordance with the provisions of section 19(a) of this title [15 USCS § 78s(a)], by filing with the Commission an application for registration in such form as the Commission, by rule, may prescribe containing the rules of the association and such other information and documents as the Commission,

by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) Determinations by Commission requisite to registration of applicant as national securities association. An association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that—

(1) By reason of the number and geographical distribution of its members and the scope of their transactions, such association will be able to carry out the purposes of this section.

(2) Such association is so organized and has the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title [15 USCS §§ 78q(d), 78s(g)(2)]) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, and the rules of the association.

(3) Subject to the provisions of subsection (g) of this section, the rules of the association provide that any registered broker or dealer may become a member of such association and any person may become associated with a member thereof.

(4) The rules of the association assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the association, broker, or dealer.

(5) The rules of the association provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which the association operates or controls.

(6) The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the association.

(7) The rules of the association provide that (subject to any rule or order

of the Commission pursuant to section 17(d) or 19(g)(2) of this title [15 USCS §§ 78q(d), 78s(g)(2)]) its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this title, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or the rules of the association, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

(8) The rules of the association are in accordance with the provisions of subsection (h) of this section, and, in general, provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the association of any person with respect to access to services offered by the association or a member thereof.

(9) The rules of the association do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.

(10) The requirements of subsection (c), insofar as these may be applicable, are satisfied.

(11) The rules of the association include provisions governing the form and content of quotations relating to securities sold otherwise than on a national securities exchange which may be distributed or published by any member or person associated with a member, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

(c) National association rules; provision for registration of affiliated securities association. The Commission may permit or require the rules of an association applying for registration pursuant to subsection (b), to provide for the admission of an association registered as an affiliated securities association pursuant to subsection (d), to participation in said applicant association as an affiliate thereof, under terms permitting such powers and responsibilities to such affiliate, and under such other appropriate terms and conditions, as may be provided by the rules of said applicant association, if such rules appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors and to carry out the purposes of this section. The duties and powers of the Commission with respect to any national securities association or any affiliated securities association shall in no way be limited by reason of any such affiliation.

(d) Registration as affiliated association; prerequisites; association rules. An applicant association shall not be registered as an affiliated securities association unless it appears to the Commission that—

(1) such association, notwithstanding that it does not satisfy the requirements set forth in paragraph (1) of subsection (b), will, forthwith upon the registration thereof, be admitted to affiliation with an association registered as a national securities association pursuant to said subsection (b), in the manner and under the terms and conditions provided by the rules of said national securities association in accordance with subsection (c); and

(2) such association and its rules satisfy the requirements set forth in paragraphs (2) to (10), inclusive, and paragraph (12), of subsection (b); except that in the case of any such association any restrictions upon membership therein of the type authorized by paragraph (3) of subsection (b) shall not be less stringent than in the case of the national securities association with which such association is to be affiliated.

(e) Dealings with nonmember professionals. (1) The rules of a registered securities association may provide that no member thereof shall deal with any nonmember professional (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

(2) For the purposes of this subsection, the term "nonmember professional" shall include (A) with respect to transactions in securities other than municipal securities, any registered broker or dealer who is not a member of any registered securities association, except such a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, and commercial bills, and (B) with respect to transactions in municipal securities, any municipal securities dealer (other than a bank or division or department of a bank) who is not a member of any registered securities association and any municipal securities broker who is not a member of any such association.

(3) Nothing in this subsection shall be so construed or applied as to prevent (A) any member of a registered securities association from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms, in connection with the purchase or sale of securities, or (B) any member of a registered securities association or any municipal securities dealer which is a bank or a division or department of a bank from granting to any member of any registered securities association or any such municipal securities dealer any dealer's discount, allowance, commission, or special terms in connection with the purchase or sale of municipal securities: Provided, however, That the granting of any such discount, allowance, commission, or special terms in connection with the purchase

or sale of municipal securities shall be subject to rules of the Municipal Securities Rulemaking Board adopted pursuant to section 15B(b)(2)(K) of this title [15 USCS § 78*o*-4(b)(2)(K)].

(f) **Exempt securities.** Nothing in this section shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security.

(g) **Denial of membership.** (1) A registered securities association shall deny membership to any person who is not a registered broker or dealer.

(2) A registered securities association may, and in cases in which the Commission, by order, directs as necessary or appropriate in the public interest or for the protection of investors shall, deny membership to any